Economic Update

NBK Economic Research Department I 20 September 2021

International Scene

Delta worries, supply shortages temper global recovery optimism

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Highlights

- **While the narrative of a recovering global economy remains broadly intact, the spread of the Delta variant, supply shortages and inflation worries are injecting a degree of caution over the robustness of the growth outlook.**
- **Weaker-than-expected August non-farm payrolls offered a further sign that US growth, although still strong, may be slowing. The Fed indicated that bond purchase tapering may start later this year.**
- **The Eurozone recorded strong growth metrics through the summer, although these too may now have peaked. The ECB announced a modest reduction in its monthly asset purchases as inflation hit a decade-high of 3.0%.**

While the narrative of a recovering global economy has remained broadly intact in recent weeks, worries over the spread of the Delta virus variant together with persistent supply shortages, the impact of rising consumer and producer prices on households and businesses and uncertainties over the Fed's QE tapering timeline, are all injecting a degree of caution over the robustness of the growth outlook. Key US and European equity markets pulled back up to 2% in early September reflecting these concerns, though are still up around 10-20% year-to-date. Meanwhile, slightly slower-than-expected US inflation in August helped eased inflation worries and supported the Fed's case that recent worryingly-high inflation rates will be transitory – although the debate is by no means over. The figures did help stem the late-summer drift upwards in US treasury yields, however, with the benchmark 10-year yield now just above 1.3%, up from below 1.2% in early August.

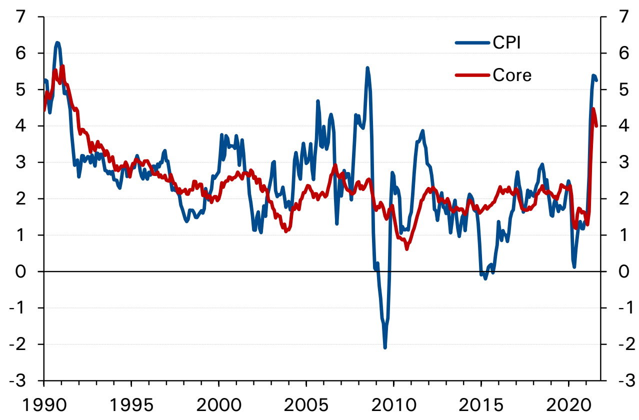
US momentum slowing, Fed seen tapering later this year

The US economic recovery remains on track, but there are increasing signs that momentum is slowing amid the surge in Delta variant cases and ongoing supply chain shortages. GDP growth for Q2, which had missed expectations, was revised slightly up to an annualized 6.6% from 6.5% previously and 6.3% in Q1. Consumer sentiment dropped to a 10-year low of 70.2 in August (81.2 in July), which was mainly attributed to the spread of the Delta variant, but also to high prices. If this weakness is sustained, consumer spending might soften further, after retail sales for July fell by a more-than-expected 1.1% m/m. In another sign of easing momentum, non-farm payrolls rose by 235,000 in August, missing consensus expectations (around 740,000) by a wide margin, although the unemployment rate decreased to 5.2% from 5.4% in July. New jobless claims edged up to 332,000 in the week ending 11 September, albeit from a pandemic-era low one week earlier.

The minutes of the July Federal Reserve meeting and Chairman Powell's speech following the Jackson Hole symposium indicated that bond purchases tapering will likely start this year, but in both communications it was stressed that tapering does not imply an imminent hike in rates once purchases have ceased. Moreover, Powell continued to strongly defend the "transitory inflation" argument, and got some support from the August CPI which came in slightly below expectations at 5.3% y/y versus 5.4% in July; the core rate inched up by just 0.1% m/m with the y/y increase softening to 4% from 4.3% in July. (Chart 1.)

Chart 1: US Consumer price inflation

(% y/y)



Source: Refinitiv

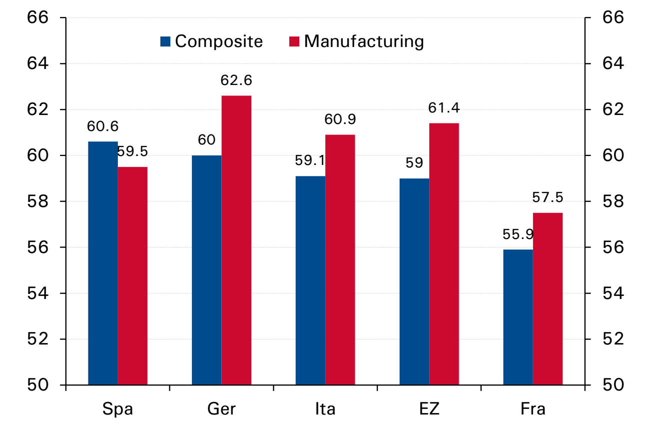
Meanwhile, the House narrowly passed the $3.5trn budget "blueprint", and locked in a 27 September deadline to vote on the $1trn infrastructure bill, effectively moving one-step closer to passing both bills later in the year. Nevertheless, the size of the budget bill may be reduced, and will most probably come with an increase in tax rates (corporate and personal), though any increases are expected to be limited, given Democrats' tightrope majority and opposition from moderate Democrats. Congress will also need to grapple with two imminent roadblocks: raising the debt ceiling (which will be reached sometime in October) and funding the government for fiscal year 2022 in order to avoid a government shutdown starting in October.

Eurozone activity rebounds in Q3 but may have peaked

Economic indicators across the Eurozone have been strong in recent months, though may now have passed their peak as the post-lockdown boom fades, supply shortages and cost rises impact businesses and amid worries over the late summer spread of Delta variant cases (although the latter seems now to be abating). The composite PMI activity gauge stood at a robust 59.0 in August, slightly down from July's 15-year peak of 60.2 but still consistent with rapid growth. (Chart 2.) Strong demand is also underpinning the labor market recovery, with the unemployment rate falling to 7.6% in July from 8.2% in April, albeit still benefitting from furlough schemes that are getting closer to being withdrawn. The above metrics look consistent with another big GDP rise of 2% or more q/q in Q3, following on from the better-than-expected 2.2% gain in Q2. Supply bottlenecks, the removal of job protection schemes and a potential new Covid wave are downside risks for later in the year, however.

Chart 2: Eurozone PMIs (August)

(index, 50=no change)



Source: IHS Markit

The European Central Bank (ECB) left policy interest rates unchanged (main deposit rate at -0.5%) at its 9 September meeting, but did announce a 'moderate reduction' in the pace of monthly PEPP asset purchases from the €80 billion of previous quarters (while sticking to its overall target of €1.85 trillion in purchases by March 2022). Aside from the improved growth outlook, the bank was also responding to more elevated inflation readings, with the headline CPI rate surging to a 10-year high of 3.0% y/y in August and the core rate jumping to 1.6% from 0.7% in July, helped by base effects and seasonal factors as well as pass-through from higher costs. Like the Fed, the ECB sees inflation falling back next year as transitory pressures fade, and receved support for this view from news that labor costs – key to any sustained spell of higher inflation – dropped in Q2 despite recent signs of job market tightening.

Japan's economic growth sees upside surprise in Q2

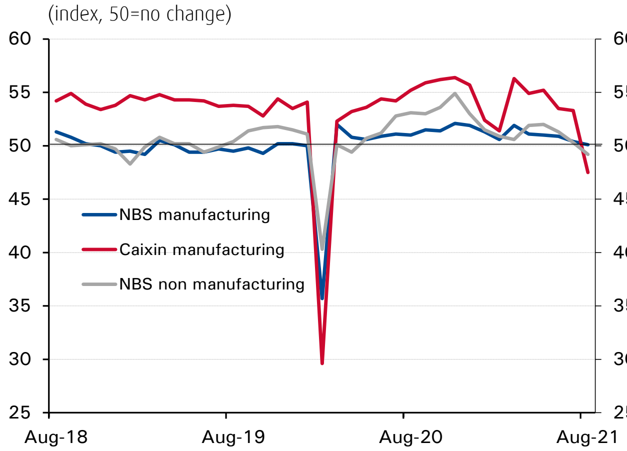
Japan's economy grew by an annualized 1.9% (+0.5% q/q) in 2Q21, beating consensus expectations of 1.3%. This was a welcome turnaround after output contracted by 4.2% in the previous quarter, and came amid a third state of emergency imposed by the authorities to contain the coronavirus pandemic. Private consumption, business investment and government spending were all stronger in 2Q21. The recovery, though, was much weaker than that of other OECD economies due to Japan's failure to contain the pandemic, a struggle that forced PM Suga to cease his bid for re-election after a rapid rise in summer infections (the state of emergency was again extended recently, to the end of September). The outlook for 3Q21 GDP growth, is, therefore, likely to be weaker as a result. Declines were observed in the August PMIs in both manufacturing (to 52.7 from 53.0) and services (to 42.9 from 47.4). Meanwhile, wholesale price inflation hit a 13-year high in July (+5.5% y/y), on the back of higher raw material imports and a weaker Yen.

Chinese economic indicators ease further

Economic indicators in China are showing signs of a slower recovery and weaker demand as the government responds to Delta variant outbreaks with tighter travel restrictions and local lockdowns (as part of its zero-Covid strategy). In August, retail sales (+2.5% y/y) and industrial production (+5.3%) both rose at slower rates, missing market forecasts and continuing the six-month downtrend. Amidst surging producer price inflation (+9.5% y/y), purchasing manager indices also fell, with both the National Bureau of Statistics manufacturing (50.1) and non-manufacturing indices (47.5) registering their weakest levels since February 2020. (Chart 3.) However, exports gave a welcome boost to the economy, beating expectations (+26% y/y) as solid foreign demand helped offset Covid disruptions.

Meanwhile, China's "common prosperity" framework, championed by President Xi, has led to significant reforms aimed at narrowing the wealth gap. In August, regulatory authorities introduced new anti-monopoly legislation, aiming to curb tech giants' influence, while government crackdowns erased billions of dollars in market value of the largest players. Simultaneously, the government has forced private education firms to restructure themselves as non-profit organizations, driving their share prices lower. The strong-arm approach has led to worries of the government derailing the private sector, which has been a vital source of growth and job creation for the economy. There are also rising concerns about possible fallout from the liquidity crisis at property firm Evergrande, especially as the government looks to discourage excessive credit growth and curb property prices.

Chart 3: China PMIs



Source: Haver

India's economy improves as Covid surge subsides

India's GDP surged 20.1% y/y in 2Q21 (1Q FY21/22) mainly on the low base from the pandemic-induced, record slump in activity in 2Q20. However, on a quarterly basis, GDP fell 17% reflecting much weaker business activity during the quarter due to a severe surge in virus cases. The virus scene has since improved drastically, leading to a rebound in activity. In August, the composite PMI surged to 55.4 (the highest since April) from 49.2 in July, helped by stronger demand and a much slower pace of job shedding. Furthermore, inflation fell to 5.6% in July from 6.3% in June, within the central bank's 2-6% target range.

Looking forward, we expect annual GDP growth to moderate in coming quarters as the prior mentioned base effect fades, but the economy should regain traction relative to previous quarters with support from recovering demand, much-reduced job shedding, and the improved virus scene. The consensus is that GDP will grow by an estimated 9.2% y/y in FY21/22, and moderate to 7.1% in the following year, albeit subject to virus uncertainty given the recent global spread of the Delta variant.

Oil prices recover after turbulent August

International oil prices closed out a turbulant August with their first monthly loss since March and their biggest in almost a year as markets fretted over rising Delta variant infections in East Asia, weakening Chinese economic growth, potentially tighter Fed monetary policy and calls by President Biden for OPEC to release more supplies into the market. While OPEC+ resisted the call and stuck to its 400 kb/d monthly supply increase (to April 2022), the arrival of Hurrican Ida in the US Gulf Coast and the damage it wrought on US oil infrastructure eventually helped prices gain more than 11% over the last 8 trading days of the month. Brent dropped 4.4% in August, closing a shade off $73/bbl.

The marker has subsequently edged higher to $75.3/bbl as of 17 September, continuing to benefit from supply issues: Ida's idling of US crude production (-1.5 mb/d to 10 mb/d in the w/e 3 September) and fears that Libyan crude supplies would be hit by protests at key oil fields and ports. On the demand side, the International Energy Agency, in its September report, estimated that the resurgent coronavirus infections in East Asia in the summer period helped pull global oil consumption down for three straight months. The agency expects oil demand to rebound over the coming months and to grow by 5.2 mb/d this year and by 3.2 mb/d in 2022. Higher global vaccine penetration rates will facilitate the economic recovery.

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